



Analysis of Transition from Contracting to Materials Tax



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The Stakeholders

As we evaluate the impact of the transition from Prime Contracting to a Materials tax, the stakeholders that will be affected are:

- ❖ The taxpayers
- ❖ The state
- ❖ The counties, through revenue sharing and county taxes
- ❖ The cities, through revenue sharing and city taxes



The Assumptions

- ▶ The assumptions that we make have interactive effects on the outcome
- ▶ The assumptions that we make in our analysis do not have the same effect on each of the stakeholders.
- ▶ The assumptions include:
 - ▶ The estimated value of current non-compliance
 - ▶ The cost of materials
 - ▶ The value of the materials that will be subject to Use Tax
 - ▶ The location of the purchase of materials
 - ▶ The future distribution base rate for the Retail category, including current retail activity
 - ▶ The distribution base rate for materials subject to the Use Tax
 - ▶ Whether a county use tax will be imposed



The Analysis

The basic math, affecting each of the stakeholders somewhere along the way, goes as follows:

$(\text{Current contracting taxable sales}/65\%) + \text{the value of (some) deductions currently taken by contractors} = \text{the estimated value of contracting from current taxpayers}$

$\text{The estimated value of contracting from current taxpayers} + \text{the estimated value of contracting from non-compliant taxpayers} = \text{the total estimated value of contracting}$



The Analysis

The total estimated value of contracting * the estimated cost of materials = the materials tax base

The materials tax base * an estimate of the portion of the materials would be purchased from out of state vendors = the materials use tax base

The materials tax base – the materials use tax base = the materials TPT tax base



The Analysis

The materials TPT tax base * the state/county combined
Retail tax rate = the state and county combined TPT tax
liability

The materials use tax base * the state/county combined use
tax rate = the state and county combined use tax liability



The Analysis

(The materials TPT tax base + the existing retail tax base) *
the retail contribution rate to the distribution base = the
retail portion of the estimated distribution base

- ▶ The analysis requires that we know what the tax base is at the state AND county level, for the purposes of county revenue sharing

The retail portion of the estimated distribution base + the
estimated distribution base for the rest of the categories
= the total estimated distribution base pool



The Analysis

The total estimated distribution base pool * county share =
total county revenue sharing

The total estimated distribution base pool * city share =
total city revenue sharing

(The total estimated distribution base pool * state general
fund share) + the total non-shared portion = total state
general fund



Interactive Impacts

It is clear that we cannot just perform the simplest analysis where:

Current taxable sales divided by 65% multiplied times the cost of materials = the tax liability under a materials tax

In that simple example, as long as the materials cost less than 65% of the construction value, then the contractors would pay less and the state would receive less

But, it just isn't that simple.



Estimate of current non-compliance

We know that by taxing materials at the source of purchase that the state will pick up taxes from businesses that are currently not paying, or are underpaying. Yet, we do not know the value of that activity under the current system.

The estimate we choose for the analysis, will likely result in:

- ▶ A **higher** amount of state and local taxes paid by businesses previously escaping taxation.
- ▶ A **higher** amount projected to be collected by the state, counties or cities;



The estimated cost of materials

We do not know the actual cost of materials. Previous analysis estimated the cost of materials to be about 41%. More recent estimates do not vary much from that.

Recognition of the estimated *cost of materials* under a new system could have the following impacts:

- ▶ A **higher** or a **lower** liability paid by existing contractors, and it could vary on a case by case basis.
- ▶ A **higher** or a **lower** amount projected to be collected by the state, counties or cities; as well as a **higher** or a **lower** amount distributed the state general fund and/or the counties or cities through revenue sharing.



Materials subject to Use Tax

We know that some materials are purchased from sources out of state. Those purchases would likely be covered under a Materials Use Tax. But, we don't know the value of those out of state purchases.

We also need to build into our analysis whether the Materials Use Tax would contribute to the Distribution Base; and whether it would be subject to County taxes.



Materials subject to Use Tax

Recognition of the *estimated value of materials purchased out of state* under a new system could have the following impacts:

- ▶ Without a county tax, contractors purchasing materials out of state would pay a **lower** state/local tax rate than contractors purchasing materials within Arizona.
- ▶ Without revenue sharing on the Materials Use Tax, the counties and cities would receive **less** in revenue sharing than they currently are from these contractors and the state general fund would receive more.



Location of the purchase of materials

We do not know where contractors buy their materials.

This is an important factor in our analysis as we evaluate the impact on county revenue sharing, county taxes and city taxes.

- ▶ The specific location of in state purchases does NOT affect the impact to the state general fund. The state tax rate and the distribution of taxes collected in total does not change based on the location of purchases.
- ▶ The specific location of in state purchases does NOT affect city revenue sharing.



Location of the purchase of materials

- ▶ Recognition of the point of sale in state materials purchases could have the following impacts:
 - ▶ A **higher** or a **lower** total local tax rate for the taxpayer
 - ▶ A **higher** or a **lower** local amount of collections for counties and cities
 - ▶ Each county could have a **higher** or a **lower** point of sale than they currently have, which would be reflected in each county's revenue sharing distribution.



Distribution Base Contribution from Retail

Retail currently contributes 40% of the 5% state tax rate to the Distribution Base. Contracting currently contributes 20%. If the contracting activity is shifted to the retail category, without a legislative change, the retail purchases would continue to contribute 40% along with existing activity. Analysis of this transition **could** include a change to that percentage.

- ▶ Any change to the retail distribution base contribution will NOT affect the amount the taxpayer pays, nor would it impact local taxes.



County Use Tax

Some discussions over the past few weeks have considered the concept of allowing the counties to impose a Use Tax on all transactions currently subject to state use tax.

While we cannot assume what decisions the counties' would make, we can include the possibility of those taxes in our model.

- ▶ The obvious impact is that taxpayers currently paying use tax could experience an increase in their tax rate
- ▶ County taxes would increase



What we need

- ▶ Additional information about the cost of materials
- ▶ Additional information about where materials are purchased

